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# Third Quarter 2022 Investment Commentary

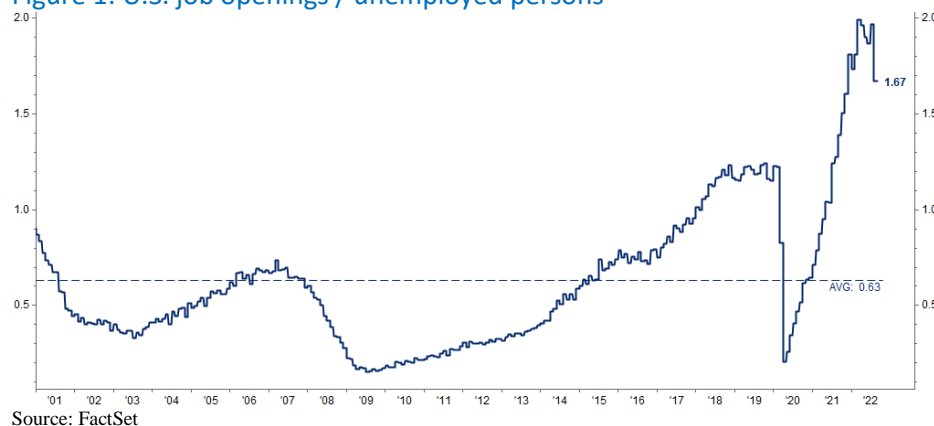
It was another challenging quarter for Canadian investors as the S&P/TSX returned -1.4% and the Canadian Broad Bond Index only a modest +0.5%. The strong U.S. dollar helped Canadians invested south of the border as the S&P 500 returned +2.2% in \$CDN (-4.9% in \$USD). International stocks languished, the MSCI EAFE Price Index returned -3.3% in \$CDN. Fully invested client accounts lagged their benchmarks in Q3 but continue to outperform this year.

## Economic Overview

The economic backdrop has deteriorated and global growth is slowing from boomy post-pandemic levels. Following 2021's 5.1%, GDP for Developed Markets is forecast to expand by roughly 2.1% in 2022 and 1% in 2023 (JPMorgan). Higher inflation and interest rates are key culprits behind the worsening macro environment although tight labour markets and healthy household balance sheets are providing some cushion.

The state of U.S. consumers is always an important consideration and, right now, they seem to be hanging in. The U.S. unemployment rate is at 3.5%, a five-decade low. Perhaps even more remarkable is the ratio of job openings to those unemployed – there are roughly 1.7 jobs available for every unemployed person in the U.S. (Figure 1). This could change quickly but it's comforting to see that businesses possess ample room to reign in hiring intentions before cutting their labour force in the event of a downturn.

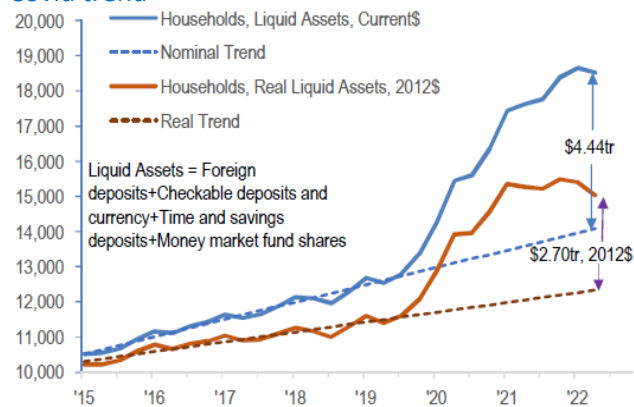
Figure 1: U.S. job openings / unemployed persons



Source: FactSet

In addition to gainful employment, many Americans still have pandemic savings. We have touched on this before, but Figure 2 again highlights the magnitude of the savings that U.S. households built up during the Covid years (roughly \$4 trillion in nominal terms) – largely thanks to federal aid, pandemic-induced spending constraints and asset-price gains. We know these reserves are being depleted as households dip into savings to keep up with inflation, but it is reasonable to expect this to offer some cushion for at least another quarter or two.

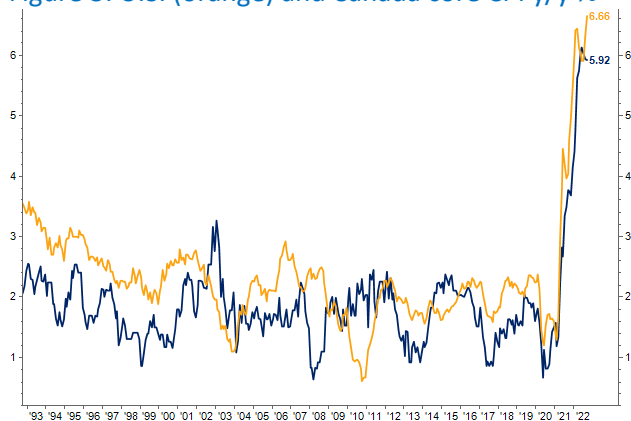
Figure 2: U.S. households’ liquid assets versus pre-Covid trend



Source: Board of Governors of the Federal Reserve System

The resilience of consumers is, however, somewhat of a double edged sword as it perpetuates inflation which is already running at problematic levels around the globe (Figure 3). Unfortunately, we probably need to see some weakness/demand destruction among households before inflation moderates to the 2% target that is widely held by central banks.

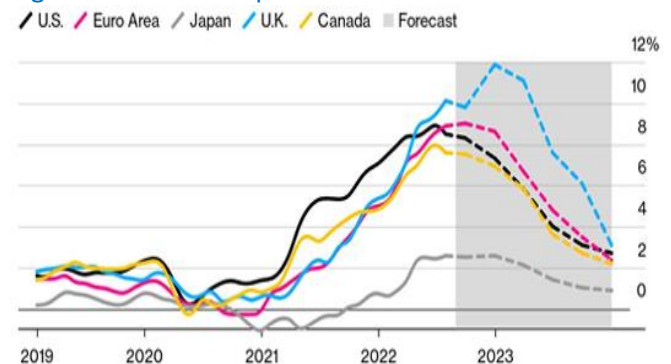
Figure 3: U.S. (orange) and Canada core CPI y/y %



Source: FactSet

The inflation path from here will be a key driver of economic (and equity markets’) performance over the near term. As it stands, markets are pricing in an eventual return to around 2%-3% annual inflation by early 2024 (Figure 4).

Figure 4: Inflation expectations

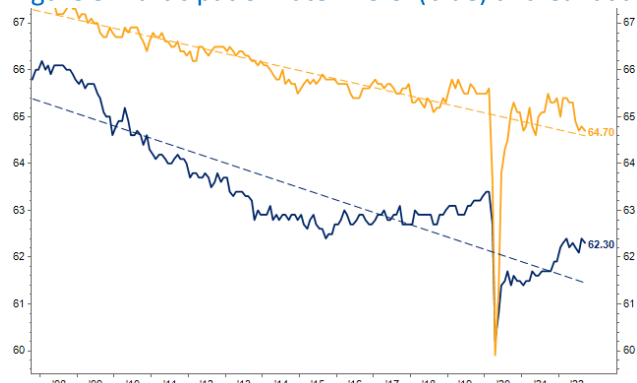


Source: Bloomberg

Visibility around this remains quite limited but we think market expectations risk being overly optimistic (inflation overshoots expectations). Rent and wage growth are perhaps the most concerning. Rents account for nearly 40% of CPI and this measure operates with a significant lag effect. On average, changes in rents are not fully reflected in CPI until roughly 8-12 months after the fact. Rent in the GTA was up 21% year over year in August and we can expect that to pressure core CPI for a long time to come.

Our other major concern – wage increase – are inherently inflationary. There seems to be a structural labour shortage (consider Figure 1) which the pandemic enhanced via early retirements and a further drop in labour force participation rates (Figure 5).

Figure 5: Participation rate in U.S. (blue) and Canada

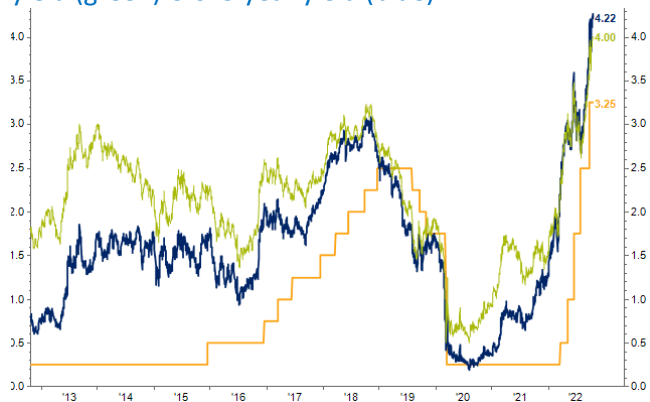


Source: FactSet

Barring an unlikely resurgence in productivity, fewer available workers should continue pressuring wages higher as companies compete for talent. What’s more, recent events have evidenced the importance of maintaining supply chains or at least production of key goods on home soil or nearby. If the effects of globalization were deflationary, it is reasonable to assume that “reshoring” or “friend-shoring” (de-globalization) will do the opposite.

The importance of where inflation goes from here cannot be overstated as it’s a key determinant of central bank policy. The Federal Reserve, Bank of Canada, and many other central banks are in the midst of raising the cost of money in attempt to reduce consumer demand and hopefully quell inflation. This rise in interest rates (Figure 6) has major implications on everyday life. Financing a home or car becomes more challenging, credit becomes more costly, and, important for investors, asset valuations decline. Consider a home-buyer with \$50,000/year of savings to put towards a mortgage. At 2.5% interest rates, that buyer can purchase a \$2 million home (ignoring bank lending requirements). At 5%, they can buy a \$1 million home. The reality today is that home sellers are clinging onto last year’s prices which the majority of buyers cannot afford given today’s higher cost of financing. The longer inflation stays higher, the longer interest rates stay higher and the greater the odds of housing prices moving down to properly align with demand. This is a pervasive dynamic throughout the economy right now and is perhaps the biggest risk we see today.

Figure 6: U.S. Fed Funds rate (orange), U.S. 10 year yield (green) U.S. 5 year yield (blue)



Source: FactSet

## Equity Commentary

Equity prices are also negatively impacted by rising interest rates, however unlike real estate, equities are marked to market on a daily basis. Stocks have already undergone a significant devaluation so far this year (Figure 7).

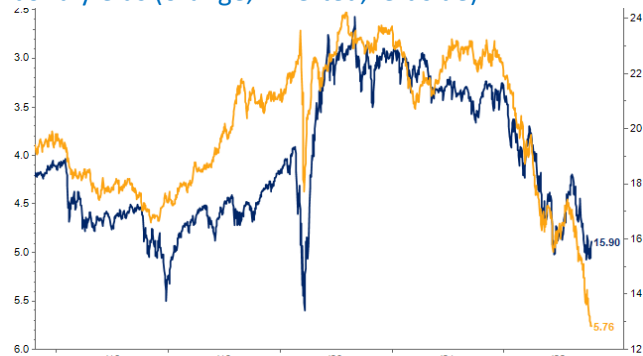
Figure 7: Benchmark equity returns this year

Index	Q1	Q2	Q3	YTD
S&P/TSX	3.8%	-13.2%	-1.4%	-11.1%
S&P 500	-5.6%	-13.6%	+2.2%	-16.7%
MSCI EAFE Index	-7.6%	-12.8%	-3.3%	-22.2%
*Returns in \$CAD				

Source: RBC Capital Markets Quant Research

The price/earnings ratio is a common valuation metric applied to stocks that reveals the price the market is willing to pay for \$1 of a company’s earnings. In 2020, the P/E multiple for the S&P 500 reached over 24x but has since declined and is now in-line with its 15-year average of ~16x. The devaluation has been nearly in lockstep with the rise in interest rates (Figure 8) – again, another reason why the direction of inflation and interest rates are important.

Figure 8: S&P 500 P/E NTM (blue) and U.S. corporate bond yields (orange, inverted, left side)

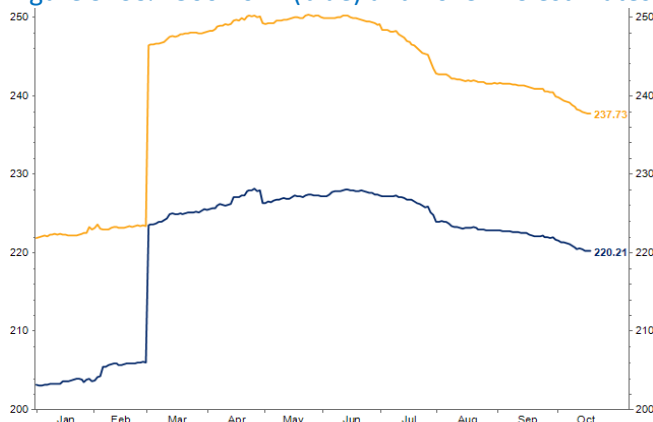


Source: FactSet

With valuations now trading around their long-term averages and well off frothy pandemic highs, stocks are certainly closer to fair value. However, that assumes that future earnings growth holds up to what we think are lofty market expectations. We have written on this frequently in the past and we are still concerned about the outlook for company profitability.

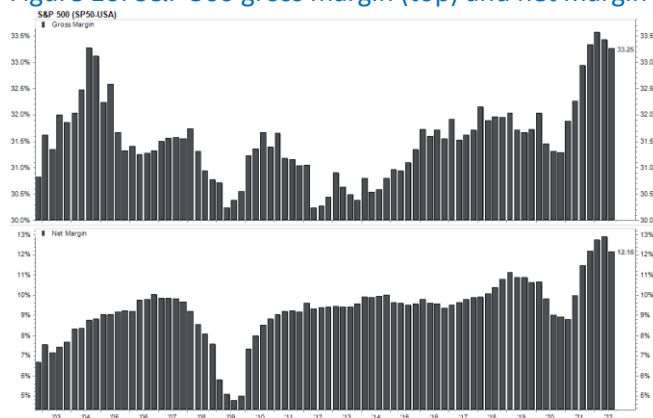
The average S&P 500 earnings per share estimate for 2022 is \$220.21 (Figure 9). Considering how far along we are in the year there is a fairly high degree of confidence around that number so probably no surprises there. For 2023 and 2024, analysts are forecasting \$237.73 and \$257.37 which assumes roughly 8% growth in both years. This seems like a high bar to us. Over the past decade, S&P 500 EPS growth averaged 7.12%. It is difficult to imagine earnings growth beating that especially as we head into an economic slowdown or possibly even a recession. What’s more, profitability was significantly lower in 2010 and the stage was set for margin expansion (Figure 10). At current peak margins/profitability it will be very difficult for companies to further leverage their sales growth into earnings growth.

Figure 9: S&P 500 2022 (blue) and 2023 EPS estimates



Source: FactSet

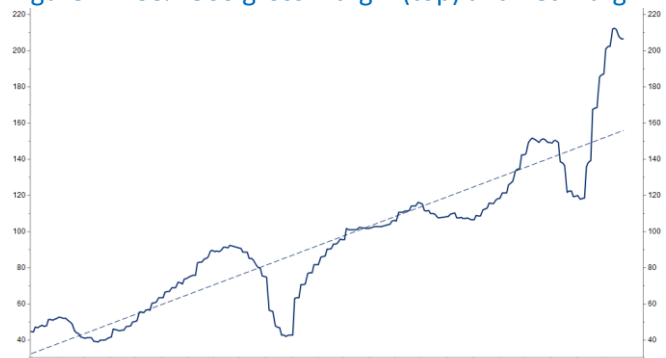
Figure 10: S&P 500 gross margin (top) and net margin



Source: FactSet

The next and last chart we have in the equity section highlights a less technical and a more intuitive line of reasoning but we think it’s worth sharing. During the pandemic, the global economy experienced a significant “pull-forward” of demand via excess consumer spending. It only makes sense that earnings growth would have experienced the same phenomenon which appears to be the case (Figure 11). S&P 500 earnings per share are well above their 25-year trend. Maintaining high growth levels from here will be challenging and we see elevated risks of companies missing their earnings expectations.

Figure 11: S&P 500 gross margin (top) and net margin



Source: FactSet

Based on the headwinds discussed we continue to maintain a defensive posture in portfolios and an underweight allocation to equities. Risks are abundant, and our focus remains centred around capital preservation as opposed to being fearful of missing out on the next rally. Defensive positioning has benefitted client portfolios, preserving more capital than the benchmark and enabling us to better take advantage of future opportunities.

## Trading

Trading was light in the third quarter as we maintained a conservative equity allocation stance. We exited our position in Facebook-parent **Meta Platforms** in July. Meta’s future is uncertain as it faces increasing competition from TikTok and it pursues a transformational investment into building its Metaverse.

In August, we positioned two real estate investment trusts as plays on surging rents in multi-residential homes. **Canadian Apartment Properties REIT** (“CAPREIT”) owns and manages about 54,000 townhouse and apartment units with approximately 40% of its properties in the Greater Toronto Area where rents recently hit an all-time high due to a shortage of housing. CAPREIT should benefit in the near term from high immigration levels into Canada and housing affordability metrics that rank near the worst levels in 40 years. We also added **Tricon Residential** which specializes in mid-market single-family rentals. The Canadian company’s operations are focused mainly in the U.S. Southeast where population growth is amongst the highest in the country from a steady inflow of people relocating to the region. The U.S. is facing a similar shortage of housing to Canada and the CEO stated they have recently received as many as 4,000 applications for a rental home.

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## Fixed Income

Interest rates were roughly flat during the third quarter and the Canadian Broad Bond Composite posted a modest gain of +0.5%, bringing the composite’s year-to-date return to -11.8%.

Typical balanced client accounts are overweight fixed income (underweight equities for reasons mentioned earlier). Our focus on high quality, short duration bonds has served portfolios well as that part of the yield curve has suffered the least in this rising rate environment. Last quarter we highlighted discount, short to medium term corporate bonds that we thought were *starting* to look attractive. We continue to like these issues as they offer solid yields, trade well below par (tax efficient), and do not possess very much duration/term risk (Figure 12). Approaching nearly 5.5% yields, these relatively low risk, corporate bonds are starting to compete with equities on a return basis while offering significantly less volatility. We think these are a great investments to not only earn a decent return but also ride out this difficult environment and again, without taking on much risk.

Figure 12: Discount corporate bonds

Bond Issue	Price	Yield	Taxable Equivalent Yield
TORONTO-DOMINION BANK 12/09/2025	\$87.64	5.45%	8.06%
MANULIFE BANK OF CANADA 2/26/2026	\$87.64	5.44%	7.85%
HYDRO ONE LIMITED 10/15/2027	\$84.40	4.99%	7.11%
TORONTO-DOMINION BANK 9/11/2028	\$82.15	5.48%	7.59%

Over the past year we reduced our preferred share weight but continue to allocate a small portion of fixed income to the asset class, mainly perpetual issues. These have sold off along with long-dated bonds as interest rates have increased but are now trading at what we feel are attractive levels. Our preferreds are yielding nearly 6.5% on average, which, for Canadian investors who are eligible for the dividend tax credit, is equivalent to a GIC yielding 8.5%. This is an excellent source of income and just as these preferreds declined due to rising interest rates, we would expect them to rally if rates moved lower.

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## Performance

Client balanced portfolios fully invested to model underperformed the benchmark return of 0.1% after fees in the third quarter but remain well ahead of the benchmark year-to-date.

Fixed income holdings lagged the 0.5% benchmark return in the third quarter. The bulk of the underperformance in fixed income for clients came from preferred shares. Client accounts on average hold 9.5% in preferreds, down from 18% in early 2021 as we reduced exposure after a period of strong returns.

Canadian equity holdings in client portfolios fell short of the -1.4% total return from the S&P/TSX Index during the quarter as interest-sensitive high dividend stocks in Energy, Real Estate, Telecommunications and Utilities sectors that had been very defensive through the first half of the year gave way to the pressure of rising yields. The hardest hit during the



quarter were **Tricon Residential** (-18.3%), **TC Energy** (-16.6%) and **Suncor** (-13.9%). Some of this damage was mitigated from positive returns from **Teck Resources** (+6.7%), **Air Canada** (+3.5%) and **Canadian National Railway** (+3.0%).

Our U.S. holdings modestly underperformed the benchmark S&P 500 Canadian dollar total return of 2.2% in the second quarter. Currency was a major factor in performance as the U.S. dollar return of the S&P 500 Index in was -4.9%. The U.S. dollar appreciated 7.3% versus the Canadian dollar in the period. Laggards included **Alphabet** (-5.7%), **Coca-Cola** (-4.5%) and **Medtronic** (-3.2%). Outperformance came from **Home Depot** (+7.9%), **Walt Disney** (+7.2%) and **Costco** (5.7%).

We held no international equities in our balanced model during the first quarter, which aided relative performance as the benchmark MSCI EAFE Index returned -3.3% in Canadian dollars.

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- In-depth **Financial Planning** – financial planning specialists will prepare a comprehensive Compass Financial Plan to help identify and address any financial planning concerns or opportunities you may have
- **Business owner planning** – help you explore succession, tax, retirement and estate planning issues you face as a business owner
- **Will & Estate consultation** – help you structure the succession of your estate in an efficient and tax effective manner
- **Insurance assessment** – Estate planning specialists assess the need and suitability of tax-exempt insurance

These services are complimentary for our clients. If you would like to take advantage of any of the wealth management services, please call **Jaana** at **416-960-7880** to schedule an appointment.



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